



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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501.00-00

509.02-01

513.00-00

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

L =

M =

O =

P =

R =

Z =

Dear :

This letter is in reply to your letter dated March 7, 2005 requesting certain rulings.

Facts

You are a nonprofit membership corporation organized under the law of the State of L. The Internal Revenue Service has recognized you as an organization described in section 501(c)(3) of the Code.

The laws of the State of L provide that M, a state agency, serves as the single state authority for coordination, planning administration, regulation, and monitoring of all facets of L's publicly funded behavioral health system including the provision of behavioral healthcare services to the "seriously mentally ill." State law provides that M is required to contract for the provision of various services to these individuals, including those who qualify under Medicaid and other similar programs. These services include community education, coordinated screening and intake, a coordinated service delivery system, coordinated case management and individualized treatment planning for each client, ongoing family participation in the planning for and selection of continuum of care services, and a comprehensive continuum of care services, as appropriate for each client, which includes, among other services "psychotropic medication services."

The statute provides that M has the authority to provide these services by contracting with certain organizations, called "Os," which must meet minimum capitalization requirements to facilitate successful contract performance. The statute requires that M's contracts with Os include terms necessary to ensure the O's financial stability and adequate performance. The statute also provides that these contracts must include terms authorizing the M to operate an O

directly if necessary to assure the delivery of uninterrupted care to clients and accomplish an orderly transition of members to a new Q, to other Qs or until the deficient Q corrects a contractual performance failure. In addition, the statute states that if the governor declares, through an executive order, that an emergency situation exists in the area of behavioral health services delivery, M may operate as the Q or award a contract to another entity to serve as the Q.

L is divided into six geographic service areas. You are one of the five Os in L. M has contracted with you and each of the other Qs for the delivery of behavioral health services to Medicaid-eligible residents within each Q's respective service area or areas.

Under your contract with M, you provide Medicaid-eligible residents in two of these service areas a broad range of mental healthcare services, including treatment services, rehabilitation services, medical services, support services, crisis intervention services, inpatient services, residential services and a behavioral health day program, and prevention services. Included in the medical services you provide are medications. Under the contract, you are required to maintain a formulary that contains the medications listed on M's medication list, to develop a monitoring system consistent with M requirements, and to "seek to obtain best pricing and pharmacy rebates for psychiatric medications purchased." (Collectively, these services are referred to as "Medication Services.")

To perform your contractual obligations, you subcontract with a number of behavioral healthcare providers to provide treatment to Medicaid-eligible residents in your service area. In addition, you subcontract with a pharmacy management company, P, an unrelated for-profit company, to provide pharmacy clearinghouse services. Under this arrangement, each month, when a client of a subcontracted provider fills a prescription at a pharmacy, the pharmacy sends the client's medication information to P. P transmits this information to you bi-monthly, and you make the appropriate payments to the pharmacies. You submit bi-monthly reports of the medications purchased to the manufacturers with which you have a rebate agreement. Because you purchase medications in such large quantities, you are able to obtain rebates directly from pharmaceutical manufacturers for certain medications. You estimate that you save approximately \$z annually for L as a result of these rebates.

M has been impressed with the cost savings and efficiencies you achieved in the provision of Medication Services in your two service areas. As a result, M has suggested that you provide these same Medication Services to other Qs in L, beginning with R. Therefore, you will contract with R for a fee to provide Medication Services to R through your subcontract with P. By providing Medication Services also to R, you will be purchasing larger volume of medications, thereby enabling you to negotiate with pharmacies for the best possible rates and contracting with pharmaceutical manufacturers for additional rebates. In addition, you expect to be able to achieve lower pharmacy transaction fees, enhance reporting capability and provide more timely pharmacy data. As a result, you expect L will realize substantial additional savings in the cost of providing medications to the Medicaid-eligible residents in R's service area.

Rulings Requested

1. Your provision of Medication Services (as described above) to R will not adversely effect your current status as an organization described in section 501(c)(3) of the Code.
2. Your provision of Medication Services (as described above) to R will constitute an activity which is not an unrelated trade or business within the meaning of section 513 of the Code.
3. The gross receipts you will receive from the provision of Medication Services (as described above) to R will constitute gross receipts from the performance of services in an activity which is not an unrelated trade or business (within the meaning of section 513 of the Code) under section 509(a)(2)(A)(ii).

Law

Section 501(c)(3) of the Code describes organizations that are organized and operated exclusively for certain purposes, such as religious, charitable, scientific or educational.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3) of the Code. But an organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1) of the regulations provides that an organization may be exempt as an organization described in section 501(c)(3) of the Code if it is operated exclusively for one or more of these purposes, including charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the regulations provides that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense. This term includes lessening the burdens of government.

Section 509(a)(2)(A)(ii) of the Code provides that the term "private foundation" includes a domestic organization described in section 501(c)(3) other than an organization which normally receives more than one-third of its support in each taxable year from gross receipts from the performance of services in an activity which is not an unrelated trade or business (within the meaning of section 513) from persons other than disqualified persons.

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived by any organization from any "unrelated trade or business" (as defined in section 513) regularly carried on by it, less certain deductions and with certain modifications.

Section 513(a) of the Code provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related to the exercise or performance of its tax-exempt purpose or function.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has causal relationship to the achievement of exempt purposes, and it is "substantially related" only if the causal relationship is a substantial one. "Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes."

Rev. Rul. 85-1, 1985-1 C.B. 177, applies the criteria set out in Rev. Rul. 85-2, *infra*, for determining whether an organization's activities are lessening the burdens of government. In this ruling, the organization was created to assist a county's law enforcement agencies in policing illegal narcotics traffic more effectively. The organization provides funds that allow the county's agents to engage in certain activities for which funds are not otherwise available. This ruling concludes that by funding activities that the county treats as an integral part of its program to prevent the trafficking of illegal narcotics, the county demonstrates that these activities are a part of its burden. Thus, the organization is lessening the burdens of the county by enabling it to augment its law enforcement activities.

Rev. Rul. 85-2, 1985-1 C.B. 178, provides that to determine whether an activity is a burden of government, there must be an objective manifestation by the government that it considers such activity to be part of its burden. The fact an organization is engaged in an activity that is sometimes undertaken by the government is insufficient to establish a burden of government. Similarly, the fact that the government or an official of the government expresses approval of an organization and its activities is also not sufficient to establish that the organization is lessening the burdens of government. The interrelationship between the organization and the government may provide evidence that the government considers the organization's activities to be its burden. To determine whether the organization is actually lessening the burdens of government, all the relevant facts and circumstances must be considered. A favorable working relationship between the government and the organization is strong evidence that the organization is actually lessening the burdens of the government.

In Columbia Park and Recreation Assoc. v. Comm'r, 88 T.C. 1 (1987), *aff'd without published opinion*, 838 F.2d 465 (4th Cir. 1998) ["Columbia Park"], the Court of Appeals upheld the decision of the Tax Court that the organization did not lessen any burden of government and thus, was not exempt under section 501(c)(3) of the Code. The organization provided a wide range of services and facilities to the residents of Columbia, Maryland. The organization contended that if it did not provide these services and facilities the local or state government would have to provide them. The Tax Court stated that this assertion does not mean that the organization's activities are, in fact, a burden of government. Instead, the organization must demonstrate that the State of Maryland and/or the county accepts the organization's activities as its responsibility and recognizes the organization as acting on its behalf. In addition, the

organization must further establish that its activities actually lessen the burden of the state or local government.

Analysis

Ruling No. 1

L law requires that M contract with Os such as you to operate its behavioral healthcare program for Medicaid-eligible residents of L. This program includes the provision of Medication Services. Your provision of Medication Services to L, through your subcontractor, P, enables you to obtain rebates from pharmaceutical manufacturers, thereby saving L substantial amounts.

You will contract with R, another O in L, to provide R with these same Medication Services. You expect L will realize substantial additional savings in the cost of providing medications to the Medicaid-eligible residents in R's service area.

The statutes of L, as described above, constitute an objective manifestation by L that it considers providing behavioral health services to "seriously mentally ill" residents of L, including Medicaid-eligible residents, as its burden. L's contract with you, pursuant to L law, demonstrates that L recognizes you as acting on its behalf in carrying out this burden. You actually lessen L's burden by saving L substantial amounts through your provision of Medication Services. See Rev. Rul. 85-1, *supra*; Rev. Rul. 85-2, *supra*; Columbia Park, *supra*. By providing Medication Services to R, at the request of L, you will continue relieving L of a burden by saving L substantial amounts associated with the cost of operating its behavioral healthcare program for Medicaid-eligible residents of L.

As a result, you will continue to operate exclusively for the exempt purpose of lessening the burdens of government (within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations) as required in section 1.501(c)(3)-1(d)(1). Consequently, your provision of Medication Services to R will not adversely effect your current status as an organization described in section 501(c)(3) of the Code.

Ruling No. 2

In Ruling No. 1, we conclude that your provision of Medication Services to R will not adversely affect your current exempt status under section 501(c)(3) of the Code because this activity furthers your exempt purpose of lessening the burdens of government within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations. Because your provision of Medication Services to R contributes importantly to furthering your exempt purpose, it will not constitute an unrelated trade or business within the meaning of section 513(a) of the Code.

Ruling No. 3

In Ruling No. 2, we conclude that your provision of Medication Services to R will not constitute an unrelated trade or business within the meaning of section 513(a) of the Code. Therefore, the gross receipts you will receive from the provision of Medication Services to R will constitute

gross receipts from the performance of services in an activity which is not an unrelated trade or business (within the meaning of section 513 of the Code) under section 509(a)(2)(A)(ii).

Rulings

1. Your provision of Medication Services (as described above) to R will not adversely effect your current status as an organization described in section 501(c)(3) of the Code.
2. Your provision of Medication Services (as described above) to R will constitute an activity which is not an unrelated trade or business within the meaning of section 513 of the Code.
3. The gross receipts you will receive from the provision of Medication Services (as described above) to R will constitute gross receipts from the performance of services in an activity which is not an unrelated trade or business (within the meaning of section 513 of the Code) under section 509(a)(2)(A)(ii).

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Steven Grodnitzky
Manager, Exempt Organizations
Technical Group 1

Enclosure
Notice 437